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IN THE

Supreme Court of the United States

October Term, 1955

No.

INGLE COAL CORPORATION, *Petitioner,*

v.

THE UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

(Filed July 29, 1955)

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Claims, entered in the above-entitled case on January 11, 1955.

CITATIONS TO OPINION BELOW

Both the majority and minority opinions of the United States Court of Claims (R. 81-90) printed in Appendix A hereto, beginning on page 1a, is reported in 127 F. Supp. 573.

JURISDICTION

The judgment of the United States Court of Claims was entered on January 11, 1955 (R. 81). The petitioner's motion for rehearing was denied on May 3, 1955 (R. 105). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(1).

QUESTION PRESENTED

Whether valid overriding royalty payments made in 1947 and 1948 pursuant to an enforceable contract entered into in 1942 are deductible by the payor thereof.

STATUTE INVOLVED

The statute involved is section 23(a)(1)(A) of the Internal Revenue Code of 1939. The provisions of this Section of the 1939 Code are printed in Appendix B, p. 30a.

STATEMENT

Only a question of law is involved. The facts have been stipulated and the Court of Claims summarized them as follows (R. 81)—

"* * * The Ingle Coal Company, plaintiff's predecessor, (hereinafter sometimes referred to as the old corporation) was a family corporation. All its stock was held by members of the Ingle family consisting of two brothers, two sisters, and the children of the brothers. The old corporation was engaged in the business of mining bituminous coal on lands held under a lease (not acquired from the Ingle family) beginning on June 1, 1940. A royalty of five cents a ton was being paid the lessor under the lease. The business had appreciated considerably in value and in the spring of 1942, an offer of $1,000,000 was made to the old corpo-

ration for its assets. The offer was rejected. The stockholders of plaintiff's predecessor decided to liquidate the corporation, transfer its assets and liabilities to the stockholders who would then transfer them to a new corporation to be organized in exchange for the stock of the new corporation and a contract obligating the new corporation to pay named individuals, who were then the stockholders, five cents a ton royalty, in addition to the royalty stipulated in the lease, on the coal thereafter mined under the above lease.

"This plan was adopted and consummated for the purpose of reducing taxes, assuring a more definite income to Katherine I. Mitchell and Frances I. Bebb, two of the stockholders, and allowing the disposition of the stock, for a lesser price, and still retaining an interest in the coal business.

"A stockholders' meeting of the old corporation was held on June 30, 1942, and a resolution was adopted that the corporation discontinue business and that its assets and liabilities be distributed to the stockholders, or their nominee, in proportion to their respective stock holdings. The president and secretary were authorized and directed to make all necessary transfers, conveyances and assignments. The stockholders agreed to accept the proposed distribution, and individually authorized the transfer and conveyance of the assets and liabilities to the plaintiff as their nominee. On the same day the directors of the plaintiff met, and after organizing and electing officers, received and accepted a proposal by the stockholders of the old corporation to convey the assets that had been distributed to their nominee, the plaintiff, to plaintiff in consideration of the assumption by the plaintiff of the

liabilities assumed by them in the liquidation of the predecessor corporation; the issuance of the plaintiff's stock in the same proportion as they had held stock in the old corporation, and also a separate agreement by the new corporation to pay them in proportion to their stock holdings in the old corporation a royalty of five cents a ton on the coal mined under the lease. Four of the stockholders also agreed to subscribe to 500 additional shares of the plaintiff's stock. The necessary legal documents for carrying out the above plan were duly executed.

"The plaintiff paid the named individuals in the contract, who had been the stockholders of the old corporation and were then plaintiff's stockholders, five cents a ton royalty on the coal mined under the lease (hereinafter referred to as over-riding royalties), in addition to the five cents a ton paid to the original lessor, and claimed a deduction therefor under section 23(a)(1)(A) for the period from July 1, 1942, to December 31, 1942, and for the year 1943. The Commissioner of Internal Revenue allowed the royalties paid to the original lessor but disallowed the over-riding royalties. The Tax Court in *Ingle Coal Corporation* v. *Commissioner,* 10 T.C. 1199, held that the over-riding royalties paid to the stockholders under the agreement were not an ordinary and necessary expense and were in substance a nondeductible dividend distribution. The United States Court of Appeals for the Seventh Circuit in *Ingle Coal Corporation* v. *Commissioner,* 174 F. 2d 569, affirmed the Tax Court on the same ground.

"Katherine I. Mitchell, recipient of 25 percent of the over-riding royalties, died on May 5, 1943. Her stock was sold to other stockholders of the plaintiff and

her rights to the over-riding royalties were distributed to her heirs and legatees. On June 28, 1944, Frances I. Bebb, recipient of 25 percent of the over-riding royalties, donated to each of her six nephews and one niece 25 shares of her stock. The gifts upset the equality of the holdings by the David Ingle and William D. Ingle branches of the family. On April 1, 1946, the remainder of her stock was sold and the equality of holdings of the two families was again attained. She retained the over-riding royalty rights.

"The over-riding royalties have been paid continuously each year since July 1, 1942. In addition to such payments dividends were paid in 1947 and 1948 in the amounts of $65,000 and $115,000, respectively.

"On its Federal tax returns for the years 1947 and 1948 the plaintiff claimed, *inter alia,* deductions for the over-riding royalties in the amounts of $42,761.10 and $34,223.70, respectively. The Commissioner disallowed the deduction and assessed an additional tax, which was paid. A timely claim for refund was filed and after six months had expired without the Commissioner's formal rejection this action was instituted."

The United States Court of Claims held that the overriding royalty payments were dividends and were therefore not deductible under the provisions of section 23(a)(1)(A) of the Internal Revenue Code of 1939. In order to hold that the payments were dividends, the lower Court ignored the 1942 reorganization and disregarded the existence of the petitioner corporation, relying upon *Gregory* v. *Helvering,* 293 U.S. 465 (1935), and related cases (R. 87). In so doing, the United States Court of Claims considered the petitioner to be in reality the same as its predecessor and held that the assumption of the obligation to pay the

overriding royalties was gratuitous for tax purposes, concluding that the payments were dividends and not deductible expenses (R. 82-88). However, Judge Madden, in a dissenting opinion concurred in by Judge Whitaker, stated that the overriding royalty payments should be deductible for the following reasons, among others: First, the transaction entered into in 1942 made permanent and important changes in the relations to the petitioner corporation of the persons who were to receive the overriding royalty payments. Second, the petitioner became unconditionally liable to make the payments whether or not it made money on its mining operations, and whether or not the persons owning the royalty rights were stockholders (R. 88-90).

The basis for the jurisdiction of the United States Court of Claims is set forth in 28 U.S.C., Section 4901.

SPECIFICATION OF ERRORS TO BE URGED

The United States Court of Claims erred:

1. In ignoring the decision of the United States Supreme Court in *John Kelley Company* v. *Commissioner of Internal Revenue,* 326 U.S. 521 (1946) and *Talbot Mills* v. *Commissioner of Internal Revenue,* 326 U.S. 521 (1946) although petitioner repeatedly called these cases to the lower court's attention.

2. In misapplying the doctrine of *Gregory* v. *Helvering, supra,* by ignoring the reorganization accomplished in 1942 which gave birth to a permanent functioning corporation on the ground that the reorganization was effectuated to save taxes.

3. In holding that the overriding royalty payments were dividends and not deductible as expenses within the purview of section 23(a)(1)(A) of the Internal

Revenue Code of 1939 although one-half of such payments were made to nonstockholders.

REASONS FOR GRANTING THE WRIT

1. The decision of the United States Court of Claims is in conflict with the decision rendered by the Supreme Court of the United States in *John Kelley Company* v. *Commissioner of Internal Revenue, supra,* which decision is set forth in Appendix C, pp. 31a-39a. In that case a corporation, all of whose common and preferred stock was owned directly or as trustees by members of a family group, was "voluntarily" recognized. This reorganization took the form of a recapitalization by which the stockholders of the corporation received only newly issued debentures in return for their preferred stock. The question before the Court was whether or not the payments on the debentures were deductible under the provisions of section 23(b) of the Internal Revenue Code of 1939 as payments of interest. This Honorable Court refused to disregard the reorganization, stating in part, on page 525:

> "There is not present in either situation *the wholly useless temporary compliance with statutory literalness* which this Court condemned as futile, as a matter of law, in Gregory v. Helvering, 293 U.S. 465. *The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentiation.* * * *" [Emphasis added.]

The Supreme Court then examined the characteristics of the obligations in question and the surrounding circumstances and determined that the payments

were ones of interest within the purview of section 23(b).

Thus, in both the *Kelley* case, *supra,* and the instant case, there were present "voluntary" reorganizations. The reorganization in the *Kelley* case, *supra,* brought about permanent changes in the corporate setup, and this Court refused to disregard the reorganization. So too in the instant case, the reorganization in 1942 brought about changes which were permanent in nature —a corporation which is still in existence and a contract under the terms of which payments are still being made. There was no "* * * temporary compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering* * * *"[1] In the instant case "* * * The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentation. * * *"[2] Actually, the facts disclose in the instant case that 50 per cent of the overriding royalty payments made during the taxable years involved were made to nonshareholders.

It is important to recognize that the court below disallowed the deductions of the overriding royalty payments solely on the ground that the new corporation, the petitioner herein, should be disregarded for tax purposes and that, therefore, the payments should be considered to have been made by the former corporation, thus resulting in merely gratuitous payments or dividends. Such disregard of a permanent operating corporation formed in 1942 in order to disallow pay-

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[1] *John Kelley Company* v. *Commissioner of Internal Revenue, supra,* at page 525.

[2] Id.

ments made by that corporation in 1947 and 1948, is clearly in conflict with the *Kelley* case, *supra*. Further, it is evident from the lower court's decision that the payments made do meet the literal requirements of section 23(a)(1)(A) of the Internal Revenue Code of 1939.

Although petitioner heavily relied in its brief and in its oral argument on the *Kelley* case, *supra*[3], the lower court ignored these cases in rendering its decision.

2. Certiorari has been granted where a Court of Appeals or the United States Court of Claims has allegedly misconstrued or misapplied applicable Supreme Court decisions. *McCandless* v. *Furlaud,* 296 U.S. 140 (1935) and *Upshaw* v. *United States,* 335 U.S. 410 (1948). In rendering its opinion in the instant case the United States Court of Claims misconstrued and misapplied decisions of the Supreme Court of the United States. The United States Court of Claims held that the transaction consummated in 1942 *had no genuine business purpose and was simply motivated by personal reasons.* Continuing, the court held that the transaction in 1942 was thus without substance. Therefore, the court ignored the 1942 transaction and disregarded the existence of the petitioner corporation. Concluding, the court held that the overriding royalty contract should therefore be treated the same as if the petitioner's predecessor corporation had assumed the obligation of paying the

[3] The attention of the court below was directed to the *Kelley* case, *supra*, in Plaintiff's Request for Findings of Fact and Brief, pp. 101, 102; Plaintiff's Motion for Rehearing and Brief in Support Thereof, pp. 15-21; Reply to Response of the United States to Plaintiff's Motion for Rehearing, pp. 2-4.

royalty to its stockholders, and therefore was merely gratuitous in nature. The entire basis for the court's ignoring the 1942 transaction and disregarding the existence of the petitioner corporation was grounded upon *Gregory* v. *Helvering, supra,* a copy of which is set forth in Appendix D, pp. 40a-43a, and related cases, and the "business purpose" doctrine set forth therein.[4]

These cases stand for the proposition that, although a tax-saving motive is insufficient by itself to disqualify a reorganization for tax purposes, nevertheless, a reorganization which involves a transitory or ephemeral corporation and which lacks "business purpose" will not be regarded as falling within the statutory definition of "reorganization", as contained in section 112 (g)(1) of the 1939 Code. Accordingly, two matters are to be emphasized: (1) these cases concerned transactions involving transitory or ephemeral corporations and (2) the question at issue was merely whether or not a statutory reorganization was involved—i.e., whether certain transfers of property were taxable or tax free. Neither factor is present in the instant case.[5]

In *Gregory* v. *Helvering, supra,* this Honorable Court held that no tax-free reorganization occurred

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[4] *Minnesota Tea Company* v. *Helvering,* 302 U.S. 609 (1938); *Griffiths* v. *Commissioner of Internal Revenue,* 308 U.S. 355 (1940); *Helvering* v. *Alabama Asphaltic Limestone Company,* 315 U.S. 179 (1942); *Bazley* v. *Commissioner of Internal Revenue,* 331 U.S. 737 (1947).

[5] The case of *Higgins* v. *Smith,* 308 U.S. 473 (1940), also relied upon by the lower court, did not involve the question whether a statutory reorganization was present. This case merely looked to whether a sale between a corporation and its *sole* stockholder was an open or closed transaction for tax purposes. It is clearly distinguishable from the instant case.

where a corporation had been formed merely for the purpose of obtaining tax benefits and liquidated three days thereafter.[6] In so doing, the Supreme Court of the United States stated beginning on page 469:

> "* * * Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? *Simply an operation having no business or corporate purpose*—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. *No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been excercised, it immediately was put to death.*" [Emphasis added.]

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[6] In that case the taxpayer owned all of the stock of corporation A, which owned 1000 shares of stock in corporation B. In order for the taxpayer to obtain possession of these shares, a new corporation C was organized to which corporation A transferred the 1000 shares of stock of corporation B. All of the stock of the new corporation—C—was transferred to the taxpayer directly. Three days later the new corporation was dissolved and the 1000 shares of corporation B stock, being all of corporation C's assets, were distributed to the taxpayer who sold them immediately and reported the profit as a capital gain. The Supreme Court of the United States held that there was no statutory reorganization and held that the taxpayer was liable as recipient of a dividend of the 1000 shares of corporation B stock.

In the *Gregory* case, *supra,* there was an ephemeral corporation formed merely for the purpose of obtaining tax benefits and liquidated three days after its creation.[7] However, applying the doctrine of *Gregory* v. *Helvering, supra,* and related cases, to those situations involving transitory transactions is one thing; but it is another thing to apply it to a situation as in the instant case where the transaction was not transitory but rather resulted in the creation of a permanent operating corporation. Also, it is another thing to apply the test to the determination of the validity of corporate obligations rather than merely to the determination whether or not a statutory reorganization existed. With the exception of the decision of the United States Court of Claims in the instant case, the doctrine set forth in *Gregory* v. *Helvering, supra,* and related cases, has never been applied so as to disregard a permanent and functioning corporation. In fact, petitioner submits that it has been decided on many occasions that credence must be given to a reorganization creating a corporation which is both functioning and permanent—irrespective of the purpose for causing the reorganization.[8]

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[7] *Kelley* v. *Commissioner of Internal Revenue, supra; Survaunt* v. *Commissioner of Internal Revenue,* 162 F. 2d 753 (CA-8, 1947); *Lewis* v. *Commissioner of Internal Revenue,* 160 F. 2d 839 (CA-1, 1947); and *Lea* v. *Commissioner of Internal Revenue,* 96 F. 2d 55 (CA-2, 1938).

[8] Where the organization of the new corporation is not a sham in that a permanent functioning corporation is formed, credence is given to the organization of that new corporation. See *Electrical Securities Corporation* v. *Commissioner of Internal Revenue,* 92 F. 2d 593 (CA-2, 1937); *Chisholm* v. *Commissioner of Internal Revenue,* 79 F. 2d 14 (CA-2, 1935), *cert. den.,* 296 U.S. 641 (1935); *Survaunt* v. *Commissioner of Internal Revenue, supra,* and *Lewis* v. *Commissioner of Internal Revenue,* 176 F. 2d 646 (CA-1, 1949).

It is clear that the lower court's reliance upon *Gregory* v. *Helvering, supra,* and the related cases cited in footnote 4, *supra,* resulted in a misconstruction and a misapplication of some of the leading decisions rendered by this Court in the field of taxation. This Honorable Court limited the doctrine of the *Gregory* case, *supra,* to transactions involving temporary compliance with statutory literalness when it stated in the *Kelley* case, *supra,* on page 525 as follows:

> "There is not present in either situation *the wholly useless temporary compliance with statutory literalness* which this Court condemned as futile, as a matter of law, in Gregory v. Helvering, 293 U.S. 465. *The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentiation.* * * *" [Emphasis added.]

No such temporary compliance exists in the instant case.

In yet another way the majority of the Court of Claims has grossly misapplied the "business purpose" doctrine as developed by this Honorable Court in *Gregory* v. *Helvering, supra; John Kelley Company* v. *Commissioner, supra; United States* v. *Cumberland Public Sales Co.,* 338 U.S. 451 (1950), and related cases. This misapplication rests in the view of the majority that certain obligations of the petitioner corporation, otherwise concededly valid, did not qualify as deductible royalty payments *only* because the reorganization giving them birth was motivated solely by the stockholders' desire to save Federal taxes. The "business purpose" test as applied to a valid, perma-

nent corporation has never been grounded solely on the touchstone of taxpayer motive and it is not so grounded today.

Nobody, certainly not petitioner, denies the eminently proper function of a court to look through the form of a transaction to determine if the transaction under scrutiny is in reality what it appears to be. The bona fides of the royalty payments here in dispute are a fitting subject for the most searching scrutiny by any court. However, under the very authorities cited by the Court of Claims, it is the court's obligation to determine the factual nature of the royalty payments for the years in question, and the legal consequences thereof, without *sole* reference to consideration of "motive" in the formation of the petitioner and the creation of the overriding royalty contract. On a factual level of inquiry, "motive" is most significant in determining what *in fact* took place; but once the content of a transaction is determined, motive is immaterial in determining the legal consequences which attach to that content. Reality—not wish nor desire nor motivation—governs the tax consequences of a transaction.[9]

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[9] The distinction here described is best grasped by comparing *Court Holding Company* v. *Commissioner of Internal Revenue*, 324 U.S. 331 (1945), with *United States* v. *Cumberland Public Service Co., supra.* These cases involved the question whether sales in liquidation made by shareholders of property previously distributed to them in kind were actually made by the corporation (if so, the corporate tax would have been imposed). In *Court Holding Company, supra,* a sale by the stockholders was found to have been actually made by the corporation, even though it had distributed the property prior to the completion of the formalities of sale. In *Cumberland, supra,* the sale was found not to have been made by the corporation under a somewhat similar set of facts. The motives of the shareholders in making the distribution

Thus, in the case at bar, motive with respect to the 1942 reorganization is irrelevant in determining the nature of the royalty payments. If this is so, the payments are concededly deductible. Under the 1942 reorganization, the corporation *was* reorganized; the old corporation did *not* survive; new, permanent relationships between the stockholders and the stockholders and the petitioner, were created; new and enduring obligations *did* come into effect under the terms of which petitioner *had* had to make payments of an additional five cents a ton in order to mine coal from the Ditney Hill Mine. To disregard the permanent operating corporation created in such a substantial transaction is clearly contrary to the law on the subject as set down by this Honorable Court.

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prior to sale were identical in both cases, namely, *avoidance of the corporate tax on sale of the property*. But in one case the tax was imposed because the sale was found to have been made by the shareholders as agents of the corporation; in the other, tax was avoided because the shareholders were found to have made the sale on their own behalf. The reality of the transaction was unimpaired by the sole motive of escaping a tax on the corporations. In the *Cumberland* case, *supra*, the Supreme Court of the United States stated, on page 455:

> "• • • The Government's argument that the shareholders acted as a mere 'conduit' for a sale by respondent corporation must fall before this finding. *The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.*" (Emphasis added.)

Indeed, "Purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation. • • •" *Lea* v. *Commissioner of Internal Revenue, supra*, at p. 57.

3. Certainly, the question presented in the instant case is of great importance in the administration of the tax laws and in the public interest. If this decision stands, the Commissioner of Internal Revenue is free to roam at will throughout myriad corporate activities and, with no more than this distorted version of the "business purpose" doctrine in hand, to strike down permanent and valid corporate transactions for no other reason than that they were entered into for tax-saving motives.

In the complex field of Federal income taxation, where concept and abstraction obscure in ever-shifting patterns the reality that lies beneath, it is altogether too easy for a court to strike down an operating corporation solely because of the apparently ignoble tax-saving motives of its shareholders (for whose personal benefit, in the last analysis, the corporate structure is always employed). But this is the very thing which this Court has said in the *Kelley* and *Cumberland* cases, *supra,* may not be done by any tribunal; and, wisely so, for the power of a court to say that what appears to be is not actually so is a terrible weapon—one that should be used with great self-restraint in conformity with authority and precedent. To repeat: Is the transaction under scrutiny in reality what it appears to be in form? If so, a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it.

CONCLUSION

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

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